Testimony of

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before the

United States Senate

Committee on Commerce, Science, and Transportation

Financial Condition of the U.S. Airline Industry

October 2, 2002

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Mr. Chairman and Members of the Committee:

I appreciate the chance to address the Committee on the current state of the US airline industry. What I would like to focus upon today is the current financial state of the airline industry and how it has been impacted since September 11th's tragic events a year ago.

Our Expectations Prior to September 11th

Going into 2001, we thought that this would be another banner year for the airlines due to robust demand. However, revenue quickly turned sour, as demand faltered due to a softening economy. This was evident in business demand for the industry, which dropped 41% year-over-year from January to July.

Acting responsibly (as opposed to the 1980s), most US airlines have shown a very quick response with respect to reining in capacity growth. There was also a move by the industry to scale back whatever costs they could. Even in the face of this, it was still going to be a year of substantial losses going into the tragic events of September 11th. Much of this is due to unavoidable costs such as wages, fuel, and maintenance, and soft demand. Our net loss estimate prior to Sept. 11th was a decline in net income for the majors of roughly $4 billion for 2001. This was getting close to the $4.8 billion loss that the industry sustained in 1992, the worst year during the past airline downturn.

The Airline Industry Post 9/11

No Sign of a Revenue Recovery

The $5 billion cash grant along with $10 billion in loan guarantees certainly stemmed what could have been even more of a disastrous financial year. In sum, the 9 U.S. majors sustained over $7 billion in losses, sharply eclipsing its level of losses in any one year of the early 1990s.

As we started to move further away from September 11th, it appeared that there were some signs of a revenue recovery and we began to become more optimistic. This proved to be short-lived, however, as rebounding demand began to falter. This is evident in pricing data, which we have charted against the average of historical (monthly from 1990-2000, a full business cycle) pricing data in order to get a better view as to what is really occurring in overall pricing.

Figure 1: **Domestic RASM Comparison**

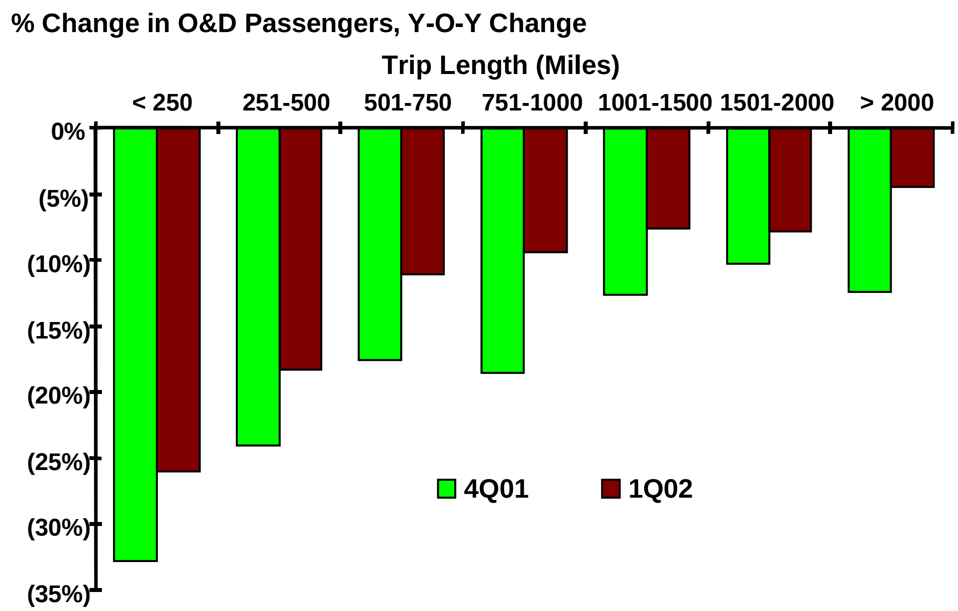
Average Domestic Monthly RASM: 1990-2000		2002 Domestic RASM		% Change
Jan	8.21	Jan	7.86	-4.2%
Feb	8.80	Feb	8.77	-0.4%
Mar	9.56	Mar	9.44	-1.3%
Apr	9.21	Apr	8.91	-3.2%
May	9.08	May	8.71	-4.0%
Jun	9.47	June	8.97	-5.3%
Jul	9.02	July	8.39	-7.0%
Aug	9.19	Aug	8.35	-9.1%
Sep	8.57			
Oct	9.02			
Nov	8.87			
Dec	8.26			

Source: Air Transport Association

Short-Haul Markets Are Down Disproportionately

With respect to demand, not only did overall traffic growth falter but it is clear that short-haul traffic has declined disproportionately more than longer-haul traffic. We think that it is due to the increased hassle factor, taxes, and overall economic sluggishness that have caused passengers to either drive or stay at home altogether.

Figure 2: **Hassle Factor, Taxes and Economic Decline Keep Passengers Aground**

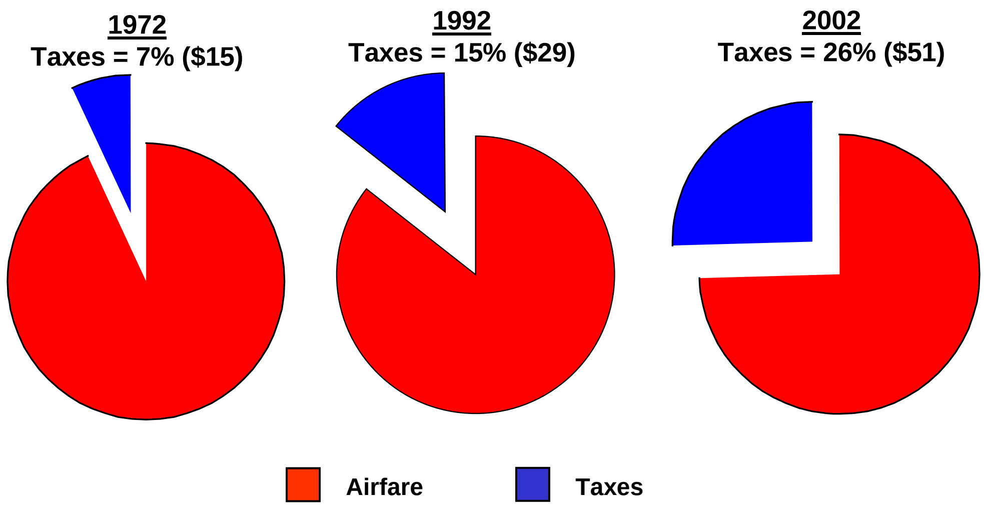


Source: Eclat Consulting using DOT O&D Survey, Alaska Air Group

Increased Fees and Taxes

The industry also continues to grapple with increased fees and taxes that have now grown to represent 26% of the price of an airline fare versus 15% in 1992 and 7% in 1972. This is even greater for the low fare airlines, representing over 30% of the price of their airline fares.

Figure 3: **Taxes Are Taking a Bigger Bite**

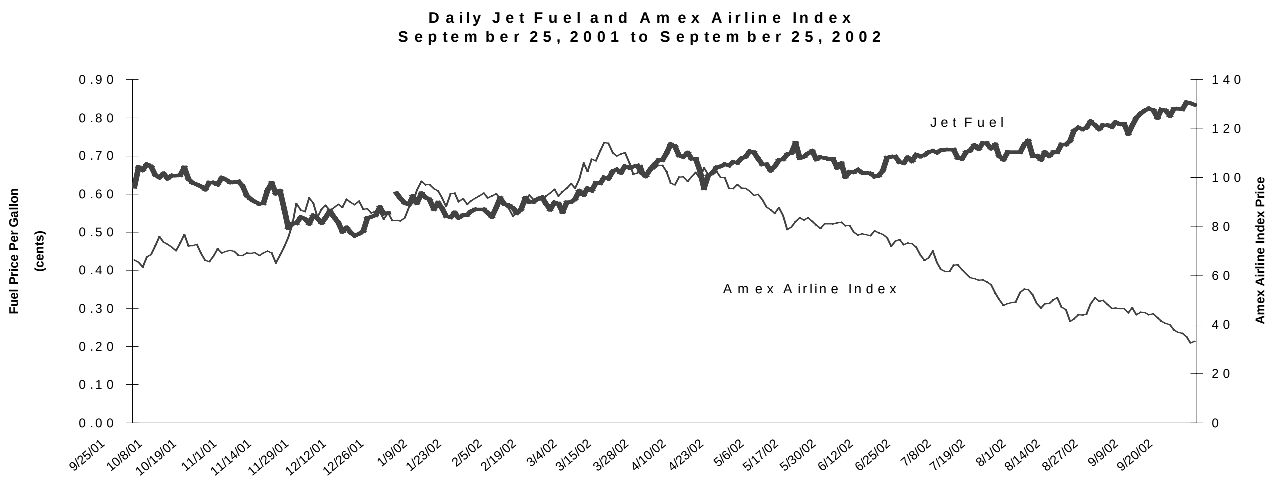


Source: Industry data. Note: Based on a $200 Single-Connection Domestic Roundtrip Ticket With $4.50 PFC

The Surge in Fuel Prices Hinder the Recovery

Last, the recent surge in fuel prices has also become quite burdensome from a cost standpoint since every $1 change in the price of crude oil results in an additional $140 million in annual operating costs for the 9 US majors.

Figure 4: **Jet Fuel Prices Versus the Amex Airline Index**



Source: Deutsche Bank Securities Inc. estimates and company information

Leverage Has Increased Dramatically

From a leverage standpoint, long-term outstanding debt, including the capitalization of off-balance sheet obligations, for the 9 majors stands at approximately $94 billion versus $88 billion at year-end 2001. The net debt/capital ratio for most of the major airlines is currently well over 80%. What this tells us is that just renewing the loan guarantee program to the industry may not be such a good idea since the industry is already burdened with a very heavy debt load. Many of these companies will, therefore, become even more highly leveraged. What may in fact happen is that very weak carriers may be forced to cut fares to cover the loans from the government, weakening the stronger airlines. We, therefore, believe that the solution is likely to be some type of tax relief for the airlines, especially if an Iraqi conflict further exacerbates the airlines' already tenuous financial position.

Figure 5: **Deutsche Bank Securities U.S. Airlines Financial and Liquidity Analysis**

Company	Revenues	Net Income	Liquidity[1]	Free Cash From Operations (FCFO) [2]	Outstanding Debt [3]	Net Debt [4]	EBITDAR net fixed charge coverage	FCFO / net debt	Net debt / capital
Airtran	$636	($17)	$109	($81)	$557	$448	0.9x	-18.1%	91.7%
Alaska	**$2,117**	**($95)**	**$707**	**($299)**	**$2,223**	**$1,516**	**1.1x**	**-19.7%**	**64.9%**
American	$17,235	($2,268)	$2,563	($5,744)	$21,745	$19,182	-0.6x	-29.9%	81.4%
America West	**$1,896**	**($214)**	**$487**	**($1,082)**	**$3,142**	**$2,656**	**0.3x**	**-40.8%**	**93.4%**
Atlantic Coast	$665	$48	$200	($50)	$1,126	$927	1.9x	-5.4%	78.0%
ATA Holdings	**$1,218**	**($57)**	**$154**	**($139)**	**$1,551**	**$1,398**	**1.0x**	**-10.0%**	**95.1%**
Continental	$8,147	($465)	$1,311	($2,104)	$16,829	$15,518	0.8x	-13.6%	93.1%
Delta	**$12,838**	**($1,303)**	**$1,841**	**($3,741)**	**$18,527**	**$16,686**	**0.4x**	**-22.4%**	**83.0%**
Northwest	$9,165	($621)	$2,807	($2,402)	$10,174	$7,367	0.4x	-32.6%	107.0%
SkyWest	**$683**	**$61**	**$364**	**($18)**	**$817**	**$454**	**NA**	**-4.0%**	**43.4%**
Southwest	$5,303	$215	$2,118	($368)	$3,334	$1,217	3.2x	-30.2%	22.4%
United	**$14,137**	**($2,064)**	**$2,704**	**($3,806)**	**$22,936**	**$20,232**	**-0.6x**	**-18.8%**	**90.3%**
US Airways	$7,166	($1,150)	$532	($2,598)	$10,175	$9,643	-0.6x	-26.9%	147.4%
Industry Range	**-**	**-**		**-**	**-**	**-**	**-0.6x-3.6x**	**-53.6% to -4.1%**	**23.5%-141.4%**
Industry Median	-	-		-	-	-	0.6x	-19.7%	90.3%

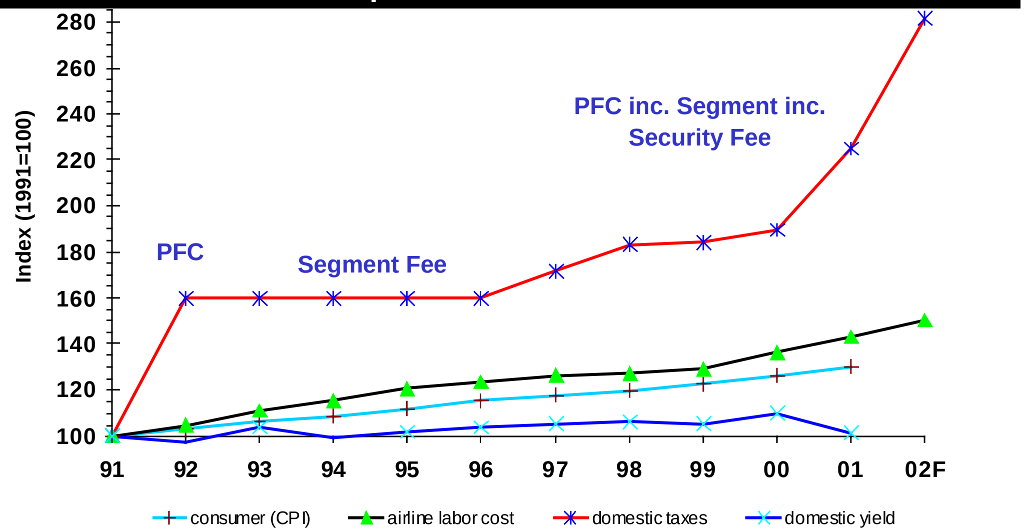
Source: Deutsche Bank Securities Inc. estimates and company information Note: All $ in millions. Income statement numbers are on a trailing twelve month basis as ofJune 2002. 1. As of June 30, 2002. 2. FCFO equals EBITDA less capex, interest expense and aircraft rental expense. 3. Outstanding debt equals long-term debt plus capital leases and capitalized operating leases. 4. Net debt equals outstanding debt less cash.

Why is this Downturn Different from the One in the Early '90s?

From a revenue standpoint, the duration of revenue weakness has already been more prolonged and precipitous. Based on the weak economy, the lack of any pricing power, airport hassle factor, fears of terrorism, continued oversupply, and a possible upcoming Iraqi conflict, we anticipate that we aren't likely to see any meaningful revenue rebound until 2004, at the earliest.

From a cost perspective, while it appears that the airlines have been reigning in what they can, taxes and fees as well as labor costs have been increasing at a rapid rate, far outpacing inflation and yields. This is putting further pressure on an already financially challenged industry. Further exacerbating the cost side of the equation is a sizable increase in post-9/11 security/insurance related costs. Our estimate is that these costs have put an additional annual cost burden on the industry between $3.5-$4.0 billion.

Figure 6: **Aviation Taxes Have Outpaced Inflation and Yields**



Source: Air Transport Association.

Figure 7: **Industry Financial Performance From Cont. Ops -- Today vs the Early 1990s**

		Operating Revenue Growth*	Operating Expenses Growth*	Operating Margin	Net Margin	Net Income
2000A-2003E						
	2000	10.7%	13.0%	6.1%	2.8%	2.8 B
	2001	-13.4%	-1.4%	-7.0%	-5.9%	(5.1) B
	2002E	-5.9%	-5.3%	-7.6%	-7.1%	(5.7) B
	2003E	1.1%	-5.3%	-0.9%	-2.5%	(2.0) B
1989A-1992A						
	1989	8.8%	12.0%	2.6%	0.2%	$132.6 MM
	1990	9.7%	15.5%	-2.5%	-5.3%	(3.9) B
	1991	-1.1%	-1.3%	-2.4%	-2.7%	(1.9) B
	1992	4.9%	5.6%	-3.1%	-3.9%	(4.8) B

Source: Company reports for the 9 US majors and DBSI estimates.

Our Expectation Going Forward

Our current industry forecast is a net loss of $5.7 billion for the 9 US majors in 2002 and $2.0 billion in 2003. Given higher-than-expected oil prices and what appears to be an imminent Iraqi invasion, we think that this amount is likely to be a best-case scenario.

Figure 8: **Industry Forecast for the 9 U.S. Majors** (from continuing operations and excluding special items)

	2000	1Q01	2Q01	3Q01	4Q01	2001	1Q02	2Q02	3Q02E	4Q02E	2002E	2003E
Financial Data												
Passenger Revenues ($ millions)	89,801	21,288	22,171	19,387	15,154	77,302	16,658	18,633	19,208	18,235	72,444	73,503
Freight & Mail Revenues ($ millions)	3,593	816	803	696	673	2,967	612	682	675	765	2,733	2,769
Other Revenues ($ millions)	5,852	1,542	1,527	1,454	1,177	5,635	1,353	1,487	1,461	1,340	5,642	5,446
Total Operating Revenues	99,246	23,646	24,501	21,537	17,004	85,904	18,623	20,802	21,344	20,340	80,819	81,719
Yr/Yr Change	*10.7%*	*3.6%*	*-5.3%*	*-17.7%*	*-30.3%*	*-13.9%*	*-21.8%*	*-16.0%*	-0.9%	*20.3%*	*-6.3%*	*1.5%*
Wage & Benefits	33,463	8,881	8,721	8,821	8,178	34,278	8,499	8,873	8,686	8,881	34,939	32,549
Fuel	13,713	3,542	3,402	3,204	2,411	12,418	2,236	2,664	2,887	2,634	10,415	9,936
Commissions	5,260	1,172	1,160	915	702	3,921	776	662	643	605	2,686	2,481
Aircraft Rentals & Landing Fees	9,328	2,347	2,253	2,236	2,338	9,000	2,307	2,342	2,367	2,534	9,550	8,898
Depreciation & Amortization	5,338	1,393	1,393	1,431	1,406	5,593	1,320	1,334	1,324	1,333	5,312	5,524
Maintenance	5,258	1,395	1,378	1,320	1,140	5,212	1,157	1,199	1,278	1,224	4,859	4,498
Food Service	831	217	215	201	181	795	184	197	175	167	724	663
Other	19,990	5,223	5,810	5,630	4,197	20,685	4,374	4,466	5,300	4,402	18,542	17,890
Total Operating Expenses	93,181	24,169	24,334	23,758	20,553	91,903	20,853	21,738	22,662	21,780	87,027	82,438
Yr/Yr Change	*13.0%*	*10.0%*	*6.4%*	*-1.5%*	*-15.1%*	*-1.4%*	*-13.7%*	*-10.7%*	*-4.6%*	*6.0%*	*-5.3%*	*-5.3%*
Operating Income ($ millions)	6,065	-523	167	-2,221	-3,549	-5,999	-2,229	-936	-1,318	-1,439	-6,208	-720
Nonoperating Income	-1,140	-470	-429	-534	-636	-2,035	-630	-684	-692	-694	-2,699	-2,548
Net Income	2,827	-609	-106	-1,725	-2,758	-5,089	-1,742	-1,023	-1,283	-1,345	-5,767	-2,026

Source: Deutsche Bank Securities Inc. estimates and company information

So What Should Be Done?

With respect to government intervention, we think that immediate tax relief should help stem industry losses since the U.S. airlines have been hit so much harder than their international counterparts. In addition, there needs to be some cost relief with respect to post 9/11 security-related costs which we estimate to be between $3.5-$4.0 billion.

Turning to airline managements and, more specifically, "the big 6" (American, Continental, Delta, Northwest, UAL Corp., and US Airways), we think that they need to figure out how to adapt to what appears to be a new operating environment. On the revenue side, this means figuring out how to adjust to a more competitive revenue environment and a weak economy. In addition, we think that many airline managements need to do a better job in pricing their product. This is evident in an average business fare which we believe is now over 7 times the average leisure fare, causing business passengers to easily justify trading down to lower fare levels, even with more fare restrictions. In addition, while we have been impressed with capacity scale-backs they have not been enough to stem the tide of weak demand. On the cost side, these airlines have to continue to attack their overall cost structures that have not been able to support the drop-off in demand and pricing. This is evident in the tables below.

Figure 9: **Comparison of "the big 6"* versus Southwest, JetBlue, and AirTran -- 2Q02A (US cents)**

	Big 6	Southwest	JetBlue	AirTran
RASM	10.5	8.4	7.7	9.1
CASM	11.1	7.5	6.3	8.5

*Source: Deutsche Bank Securities Inc. estimates and company information * RASM: Opg Revs/Available Seat Mile, CASM: Opg. Expenses/ASM.*

Figure 10: **Comparison of "the big 6"* versus Southwest, JetBlue, and AirTran -- 2Q02A (US cents)**

	Big 6	% of CASM	Southwest	% of CASM	JetBlue	% of CASM	AirTran	% of CASM
Wages & Benefits/ASM	4.6	42%	2.9	39%	1.9	31%	2.4	29%
Fuel Expense/ASM	1.3	12%	1.1	15%	0.9	14%	1.9	22%
Maintenance/ASM	0.6	5%	0.6	8%	0.1	1%	0.7	8%
Commisssions/ASM*	0.4	3%	0.1	1%	0.6	10%	0.9	10%
Rentals & Landing Fees/ASM	1.2	11%	0.8	10%	1.0	16%	1.3	15%
Depreciation & Amort./ASM	0.7	6%	0.5	7%	0.3	5%	0.2	2%
Other/ASM	2.4	21%	1.5	20%	1.5	23%	1.2	14%
Sum	***11.1***	***100%***	***7.5***	***100%***	***6.3***	**100%**	***8.5***	**100%**

*Source: Deutsche Bank Securities Inc. estimates and company information. * Commissions/ASM may include other distribution expenses as well.*

Disclosures

Company	Ticker	Price	Disclosure
Alaska Air Group	ALK	$17.70	None
AMR Corporation	AMR	$4.18	6
America West Holdings Corporation	AWA	$1.45	None
Continental Airlines, Inc.	CAL	$5.39	6
Delta Air Lines	DAL	$9.29	6
Southwest Airlines	LUV	$13.06	6
Northwest Airlines Corporation	NWAC	$6.68	1,2
UAL Corporation	UAL	$2.14	6
AirTran Holdings, Inc.	AAI	$3.11	None
Atlantic Coast Airlines, Inc.	ACAI	$9.25	1,2
ATA Holdings Corp.	ATAH	$3.40	2
JetBlue Airways	JBLU	$40.33	None
SkyWest, Inc.	SKYW	$13.10	2,6

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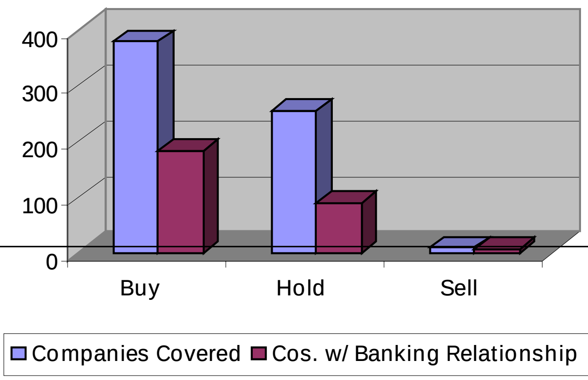

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